



IPSA Guide to Executive Share Option Schemes

Introduction

An executive share option scheme ("ESOS") is a discretionary share option scheme used by an employing company to remunerate and motivate its senior executives and employees. It may also prove to be a useful tool in recruiting and retaining key executives. Typically the employer has discretion as to who receives share options under the ESOS.

As there are no particular tax concessions in Ireland associated with an ESOS and therefore no requirement to obtain approval for the scheme from the Revenue Commissioners there is scope for maximum flexibility in its design. The key to implementing a successful ESOS is to design the scheme to achieve the objectives desired by the employer.

Outline

The principal features of an ESOS are as follows:

- the relevant company designs the scheme, obtains shareholder approval for its implementation, adopts the scheme and selects the executives who will participate;
- the executives are granted options to acquire shares, usually with an exercise price of the then prevailing market value;
- after a minimum period of three years the executives may exercise all or part of their options at a time chosen by them and acquire the shares for the original market value; and
- options may be granted at intervals chosen by the employer.

Design considerations

The ESOS must comply with the institutional investor guidelines (e.g. the IAIM for Irish listed organizations) and stock exchange requirements if relevant which would require, for example, that employees may not be granted options over shares to a value of more than four times annual salary. Company law may also impact on the design of an ESOS.



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As well as dealing with operational aspects of the scheme the rules may also impose performance criteria which must be met before the options granted under the scheme become exercisable, for example, growth in earnings per share or total shareholder return. These performance criteria would normally be determined by the Remuneration Committee.

A company may choose to include second-tier options in the ESOS as well as basic-tier options. Second-tier options only become exercisable on the achievement of higher levels of sustained performance over a specified period. For example, the current IAIM guidelines provide for basic-tier options to become exercisable so long as earnings per share (EPS) growth is at consumer price index (CPI) levels plus 5% compound per annum. For second tier-options, the sustained performance measure required is typically ESP growth at CPI plus 10% per annum along with a positioning vis-à-vis growth levels within the upper quartile of a pre-defined peer group.

Option grants and shares used

The options can be granted over shares in the company which established the scheme or perhaps its parent company. In some cases, the shares will ultimately be delivered via the trustees of an employee benefit trust set up for the purpose of operating the ESOS.

If the shares are not quoted on a stock exchange it may be necessary for them to be valued on a regular basis. For example, a market value on grant will be required generally to ensure the shares are being granted at the prevailing market value, if that is what the scheme rules provide for. In addition, the market value at exercise is critical to establishing whether there is an economic benefit to actually exercising the options and thereafter to calculate any tax liabilities. Valuations are often undertaken by professional valuation experts or internally using an agreed formula.

Whatever means are adopted to arrive at the exercise price it should be agreed with the Revenue Commissioners (who will need to determine the fair market value at grant,



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exercise and sale). Where the life of the option does not exceed seven years no charge to income tax will arise on grant in which case a formal valuation may not necessarily be required from a Revenue standpoint.

Option exercise

After the vesting period has elapsed the executive will have a window within which to exercise. Upon exercise, his option he will acquire the shares from the company or the trustee, in return for paying the exercise price for the relevant number of shares.

Where shares in an unlisted company are involved, the rules of an ESOS may require a leaver to sell his shares acquired on exercise in which case the employer would typically ensure that there is a mechanism to purchase those shares at some agreed valuation (and the articles of association would often require such action).

Tax treatment

No income tax, universal social charge (USC) or PRSI is payable on the grant of an option provided it cannot be exercised after its seventh anniversary. If the exercise price is less than the market value on grant and the option has a life span in excess of seven years an employee will be liable to pay income tax, USC and employee on the discount at the time of grant.

When stock options are exercised, the individual becomes liable to income tax, USC and employee PRSI on the difference between the exercise price and the actual stock price on the date of exercise. The taxes due must be paid within 30 days of exercise and a form RTSO1 must be filed along with the payment due. The exercise of a stock option brings the participant within the self-assessment tax system which imposes automatic tax payment and filing obligations. Participants in a stock option scheme should obtain professional tax advice in this regard.

Where the shares are shares in the employer company, or a controlling company, there is no



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employer PRSI charge on the gain made on exercise.

If an employee disposes of the shares he/she is liable to capital gains tax subject to the usual exemptions and reliefs. The base cost of the shares acquired on the exercise of an option will be the market value of the shares at the date of exercise.

Corporate tax deductions should be available for the costs of administering an ESOS.

Accounting Issues

If the ESOS is operated through an employee trust, it may be necessary to consolidate the assets and liabilities of that trust with those of the employing company.

If options are granted with an exercise price of less than the market value at the date of grant, the employing company may need to recognise the discount as a charge in its profit and loss account (and the employees may be liable to income tax as noted above).

Appropriate professional advice should be taken in advance in relation to the correct accounting treatment to be applied.

The foregoing reflects current tax rules and Revenue practice which is subject to change. This document is of a general narrative only and should not be regarded as a substitute for professional advice. Such advice should always be taken before acting on any of the matters discussed.

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